IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. 28

CLARIDGE APARTMENTS COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

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MAY IT PLEASE THE COURT:

OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 183-199) is reported in 1 T. C. 163. The opinion of the Circuit Court of Appeals for the Seventh Circuit (R. 228-237) is reported in 138 F. (2d) 963.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on December 1, 1943, and petition for rehearing was denied on December 22, 1943 (R. 238). Petition for certiorari was filed February 15, 1944, and granted March 27, 1944. The jurisdiction of this court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. Section 347(a)).

QUESTIONS PRESENTED.

(1) Should the Circuit Court of Appeals affirm a decision of the Tax Court "when there is found to be rational basis for the conclusions approved by the administrative body"?

(2) Is indebtedness "canceled or reduced" within the meaning of the Chandler Act by the difference between the amount of the debt and the fair market value of the stock which creditors received in exchange for the debt?

(3) The statute involved in the case at bar was enacted June 22, 1938, and became effective September 22, 1938. The reorganization plan was confirmed by the District Court May 14, 1935 (R. 187), and final decree was entered March 1, 1937 (R. 187). Thus, the proceeding was not pending when the statute involved in the case at bar became law, having terminated over a year and six months prior thereto. The question which arises on this state of facts is whether section 270 of the Chandler Act applies to proceedings not pending at the time of its enactment?

(4) Assuming that Section 270 of the Chandler Act applies to proceedings not pending at the time of its enactment but terminated long prior thereto, is it retroactive so

as to apply to the computation of income taxes for years prior to its enactment, as the court below held, or does it only apply to such plans for purpose of tax computation starting with the year of its enactment as the Tax Court held in the case at bar and as the Circuit Court of Appeals for the Sixth Circuit has held?

STATUTE AND REGULATIONS INVOLVED.

The statute and regulations involved are set forth in the appendix. The statute does not define the word "canceled." The regulation merely repeats the statute and does not purport to clarify it.

STATEMENT.

The facts, as found by the Tax Court, so far as material to the questions involved in this case (No. 28), are as follows:

The taxpayer is a corporation organized on May 28, 1935, under the laws of the State of Illinois, pursuant to a proceeding under Section 77-B of the Bankruptcy Act. It filed its income and excess profits tax returns for the years 1935 to 1938, inclusive, with the Collector of Internal Revenue for the First District of Illinois (R. 184).

In determining deficiencies for each of these years the Commissioner reduced the depreciation allowance claimed by the taxpayer on its returns (R. 9, 12, 15-16, 18-19) because he claimed the basis for depreciation was the fair market value of the property "on the date you acquired it, August 1, 1935, or $132,500" (R. 9), instead of the basis to taxpayer's predecessor.

The Commissioner did not apply section 270 to this case. If he had he would have valued the property as of the date of the order confirming the plan (May 14, 1935) as section 270 provides (R. 84). Instead, he issued the notice of deficiency solely on the theory that no tax free reorganization took place. He stated in said notice:

> "It has been determined that your basis for depreciation on the apartment building was the fair market value of the property on the date you acquired it, August 1, 1935, or $132,500." (R. 16.)

The Tax Court found:

In 1924 the Claridge Building Corporation (herein called the Building Corporation) acquired a certain lot in Chicago from Charles F. Henry, pursuant to a contract whereby the Building Corporation agreed to issue and did issue its entire authorized capital stock to Charles F. Henry in consideration therefor. During the spring and summer of 1924, the Building Corporation caused an apartment building to be erected on the lot at a cost of $385,326.37. By August 1, 1935, depreciation amounting to $139253.71 had been taken on a "cost" of $424,609.19, which included a contractor's commission to Charles F. Henry (R. 184).

On March 25, 1924, the Building Corporation issued its 6½ per cent first mortgage bonds in the principal amount of $340,000. By October 1, 1931, the bonds were outstanding and unpaid in the principal sum of $277,000. Defaults having occurred both in principal and interest, the trustee filed a bill for foreclosure on October 1, 1931, and all of the bonds were declared immediately due and payable. A decree of foreclosure was entered on February 19, 1933, but there was no sale of the mortgaged property under

the decree and the foreclosure proceeding was never consummated. The trustee took possession of the property and collected the rents after October 1, 1931 (R. 184).

On June 7, 1934, section 77-B was added to the Bankruptcy Act and on June 16, 1934, the Building Corporation filed a voluntary petition in the District Court of the United States for the Northern District of Illinois, Eastern Division, under Section 77-B of the Bankruptcy Act, as amended (R. 185).

On November 27, 1934, the bondholders' committee, the Building Corporation, and one Minnie H. Case agreed on a reorganization plan. The plan provided for the formation of a new corporation to acquire the property. The new corporation would have an authorized capital stock of 3,080 shares. Ninety per cent of the outstanding stock, or 2,770 shares, would be held by trustees, and the trust certificates would be issued to the bondholders on the basis of one share of stock for each $100 face amount of bonds. Ten per cent of the stock would go to the old stockholders (R. 185). This plan was confirmed and approved by the court by an order dated May 14, 1935. The order stated that the bonds and interest coupons were satisfied and of no further force and effect and authorized the issuance of the new securities for them (R. 187):

The taxpayer was organized pursuant to the plan and the property transferred to it (R. 188). Under the plan the taxpayer's stock was issued at the rate of one share per $100 face value of the bonds of the old company. The fair market value of the stock never exceeded $45 per share at any time during the year 1935. Of taxpayer's 3,080 shares of common no par value stock, 2,770 shares were issued to non-depositing bondholders and to trustees

for the depositing bondholders, 308 shares to old stockholders and 2 shares remained unissued (R. 189).

DECISION OF THE TAX COURT.

The final decree in the Section 77-B proceeding entered March 1, 1937, declared the first mortgage bonds in the principal amount of $277,000 and interest coupons attached and the trust deed and chattel mortgage, which secured them, to be of no further force and effect as against the debtor and its property, and that the holders thereof should, in lieu thereof, be entitled to receive only the new securities provided for in the plan of reorganization (R. 187).

The Tax Court held that the bonds were not "canceled or reduced" within the meaning of the statute because they were exchanged for stock and the bondholders took the property of the debtor in exchange for their bonds.

The Tax Court also followed its decision in *The Commodore*, 46 B. T. A. 712 (since affirmed by the Circuit Court of Appeals for the Sixth Circuit in 135 F. (2d) 89), and held that no tax year earlier than 1938 (the year the Statute was enacted) would be effected by section 270 of the Chandler Act, which became effective September 22, 1938.

Upon appeal, the learned court below did not consider whether the decision of the Tax Court rested upon a rational basis. It brushed aside the holding of the Tax Court and the holding of the Circuit Court of Appeals for the Sixth Circuit on the non-retroactivity of the statute with the statement "the legislative intent here is not left in doubt."

It also overruled the holding of the Tax Court that the debt was not "canceled" because it was exchanged for stock and because the property was taken in satisfaction of it with that statement that "stock was not a debt" (R. 232). No one ever contended it was. That it is not a debt is a false and immaterial issue.

SPECIFICATION OF ERRORS.

The Circuit Court of Appeals erred:

(1) In failing to hold the decision of the Tax Court rested upon a rational basis and therefore should be affirmed;

(2) In holding that debt had been "canceled" by the exchanging of stock for it in the 77-B proceeding;

(3) In holding that the statute was retroactive so as to compel the reopening of cases and the recomputation of income tax liability for years prior to its enactment; and

(4) In failing to hold that the section of the Chandler Act involved in the case at bar did not apply to proceedings which were not pending at the time of its enactment, and in which a final decree had been entered prior thereto.

SUMMARY OF ARGUMENT.

(1) It is first submitted the decision of the Tax Court was a reasonable, rational and plausible construction of Section 270 and, therefore, should not have been reversed.

(2) It is next submitted that, considering the question *de novo* and wholly unfettered by any deference to the Tax

Court's decision, it must be concluded Congress intended by Section 270 what the Tax Court said it did.

(3) Section 270 is not retroactive beyond the date of its enactment is the next point made.

Finally, as point (4), it is submitted Section 270 does not apply to proceedings under 77-B in which a final decree was entered prior to the enactment of the Chandler Act but only to proceedings then pending under Section 77-B and those commenced thereafter under the Chandler Act. It is necessary, in any event, to decide this point because of the Tax Court's holding that the basis must be reduced for 1938 and subsequent years by the amount of the canceled interest. This question (4) was overlooked by the Tax Court.

When the Court below decided the case at bar, it did not have the benefit of this court's decision in *Dobson* v. *Commissioner*, 320 U. S. 489, wherein this court observed at p. 501, "the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body"; that the decision of the Tax Court must stand unless the Appellate Court can identify a "clear-cut mistake of law" (at p. 502). In this case, as in that, "the statute gives no inkling of the correctness or incorrectness of the Tax Court's view" and there is no regulation purporting to explain in what circumstances debt is "canceled."

Conceding the court below was empowered by the statute (I. R. C. sec. 1141(c)(1)) to reverse the decision of the Tax Court, if it was "not in accordance with law," it is submitted that before it could do so it was encumbent on the appellant to show that the Tax Court's decision

was plainly, obviously, patently and palpably contrary to law and not merely raise doubts about it. Also, the Appellate Court should not, as it did in the case at bar, approach the legal question as if it were sitting *de novo* in a trial court but should indulge every presumption in favor of the Tax Court's decision and make the appellant discharge the burden of demonstrating clearly and beyond reasonable doubt that the decision below was not in accord with statute and, if the Tax Court's decision is a reasonable and rational application of the statute, it should be affirmed albeit the Appellate Court can think of a more reasonable one. The Appellate Court should "conform to if when possible." (*Dobson* case, 320 U. S. 501, 502.) Only thus can a flood of tax litigation of such avalanche proportions as to overwhelm courts be avoided and prompt collection of the revenue, reasonable certainty in tax questions essential to business transactions and due regard for administrative agencies be obtained. Only thus can we avoid a hodge-podge, sick-making mess being brewed by a variety of inexperienced, uninformed, unqualified cooks. In the *Dobson* case this court held the decisions of the Tax Court were entitled to "at least" equal respect to those of other administrative agencies and, as pointed out in *Gray* v. *Powell*, 314 U. S. 402, patently to attach special weight only to findings of fact and not to conclusions of law is to reduce the administrative agency to a mere fact finding commission. (Cf. *National Labor Relations Board* v. *Hearst Publications*, 322 U. S. 111, at p. 131) or agency to certify facts to the Circuit Courts for determination of their legal effect.

There is no difference between the principle for which we contend and the old, well established principle that a regulation interpreting a law, has the force of law if it is a rational interpretation. Indeed, our contention is sup-

ported by stronger reason, because, as observed in the *Dobson* case, the Tax Court is impartial, whereas the Revenue Bureau acts not impartially and judiciously but contentiously in the knowledge that, if it rules a doubtful matter in favor of taxpayers, its right to litigate the question is thereby foreclosed. Also, a regulation is made *ex parte* but a Tax Court's decision only after hearing. In other words, when an administrative agency, acting within scope of its statutory authority to promulgate regulations, considers a statute and makes a regulation which is a rational and plausible interpretation of the statute, such regulation has the force of law even though a court charged with the same duty might have promulgated a different regulation or even though a reviewing court can think of a more reasonable one.[1] *A fortiore* when the Tax Court, acting as an administrative agency, promulgates a decision interpreting a section of the taxing statute and such

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[1] On page 21 of his brief in the court below, respondent states as follows:

> "Moreover, it is also a well recognized canon of construction that an administrative interpretation is entitled to great weight and should not be disturbed unless plainly wrong. *Fawcus Machine Co.* v. *United States*, 282 U. S. 375; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349; *Spring City Co.* v. *Commissioner*, 292 U. S. 182, 189; *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90; *Helvering* v. *Reynolds*, 313 U. S. 428, 433-434; *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326, 337-339; *White* v. *Winchester Club*, 315 U. S. 32, 41; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44, 47-48."

If such weight is given an *ex parte* regulation, which does not state any reasons for its conclusion, much more weight should be given the considered determination of the Tax Court experts (who are more expert than the Bureau experts) because they are impartial, decide only after hearing and state the reasons for their conclusions.

decision is rational and not plainly contrary to the words of the statute or to any regulations of the Treasury Department interpreting the statute, it follows by analogy that such decision has the force of law and cannot be overturned by the courts. Before it can be overturned, it must be obviously contrary to the plain words or clear purpose of the statute. In such case it is not a rational interpretation. The Appellate Court "should not be permitted to search for the correct interpretation of a statute, after an administrative agency has made such a determination, but should merely inquire as to the reasonableness of the particular determination which has been made." 47 Yale Law Journal 597; 9 George Washington Law Review 514.

On the second phase of the argument and wholly apart from the above, the Tax Court should be affirmed and the court below reversed because the debt was not "canceled" when exchanged for stock. This conclusion follows whether the Statute be considered alone and the word "canceled" given the meaning in which it would ordinarily be understood in its statutory setting or whether its meaning be considered doubtful and resort be had to legislative history for enlightenment. The committee reports state, as plainly as language can, the statute in question was designed "to prevent a double deduction" and to embrace cases of "debt forgiveness." No debt forgiveness is present here and no double deduction. Instead of forgiving the debt, its owners exacted their pound of flesh for it, exchanged one evidence of ownership for another, and the conclusion of the Tax Court that a non-taxable reorganization took place is not challenged by respondent here. Also, the construction contended for by respondent would discriminate against corporations undergoing in federal bankruptcy a non-taxable reorganization in fa-

vor of corporations doing the identical thing in state court proceedings and in favor of solvent corporations exchanging bonds for stock. It would impose the burden of section 270 on a corporation which had no benefit from section 268. This runs counter to the rule requiring liberal construction of bankruptcy acts to help the bankrupt, the further rule that remedial legislation is to be construed liberally, to the still further rule that doubts are to be resolved in a taxpayer's favor and to the constitutional requirement that excises must operate uniformly.

On the third point, the Tax Court and the Circuit Court of Appeals for the Sixth Circuit are patently right in holding section 270 inapplicable in the computation of income taxes for taxable years prior to its enactment (1938) and the court below is wrong in holding it retroactive to and including 1934 and in requiring reopening and recomputation of income taxes for the years 1934, 1935, 1936 and 1937, for which income tax returns had been filed before section 270 became law on September 22, 1938. If Congress had intended to carry the statute back five years, it would have plainly said so. Instead, the committee report said future tax liability only was effected. Also, if such a construction does not render the statute unconstitutional, it at least raises a constitutional doubt and a construction which does this is to be avoided. *United States* v. *Moy*, 241 U. S. 394, 401.

Finally, it is submitted the Chandler Act does not apply to proceedings in which final decrees had been entered before it was enacted. They were not pending at the time and their reorganization plans could not be revised in the light of the Act.

ARGUMENT.

I.

The Tax Court's Construction of the Statute Was a Rational, Reasonable and Plausible One and Should Have Been Affirmed on this Ground Alone.

In *Dobson* v. *Commissioner*, 320 U. S. 489, this court recognized that the statute grants authority to Circuit Courts of Appeal to reverse the decisions of the Tax Court when "not in accordance with law." However, this court stated (p. 501): "The judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body."

This court also said of the Tax Court, at pages 498 and 499:

> "The court is independent, and its neutrality is not clouded by prosecuting duties. Its procedures assure fair hearings. Its deliberations are evidenced by careful opinions. All guides to judgment available to judges are habitually consulted and respected. It has established a tradition of freedom from bias and pressures. It deals with a subject that is highly specialized and so complex as to be the despair of judges. It is relatively better staffed for its task than is the judiciary. Its members not infrequently bring to their task long legislative or administrative experience in their subject. The volume of tax matters flowing through the Tax Court keeps its members abreast of changing statutes, regulations, and Bureau practices, informed as to the background of controversies and aware of the impact of their decisions on both Treasury and taxpayer. Individual cases are dis-

posed of wholly on records publicly made, in adversary proceedings, and the court has no responsibility for previous handling. Tested by every theoretical and practical reason for administrative finality, no administrative decisions are entitled to higher credit in the courts. Considerations of uniform and expeditious tax administration require that they be given all credit to which they are entitled under the law."

This court also said, "Every reason ever advanced in support of administrative finality applies to the Tax Court."

Inasmuch as the decisions of the Tax Court are entitled to at least equal credit with those of other administrative bodies, it is important to consider the effect of such other decisions on appeal and the scope of judicial review thereof. As to the Interstate Commerce Commission, this court in *Rochester Telephone Corp.* v. *United States*, 307 U. S. 125, at page 140, said, "Only questions affecting constitutional power, statutory authority and the basic prerequisites of proof can be raised. If these legal tests are satisfied, the commission's order becomes incontestible."

In that case this court also declared, at page 146, the rule for review of decisions of the Federal Communications Commission. This court said: "So long as there is warrant in the record for the judgment of the expert body, it must stand." It then said: "The judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body."

In *Gray* v. *Powell*, 314 U. S. 402, involving a decision of the Director of the Bituminous Coal Commission, it was

contended the courts on review might consider questions of law *de novo* but this court, at page 412, stated that under such a view "executive or legislative agencies become mere fact-finding bodies deprived of the advantages of prompt and definite action." The court also said: "Certainly a finding on Congressional reference that an admittedly constitutional act is applicable to a particular situation does not require such further scrutiny. Although we have here no dispute as to the evidentiary facts, that does not permit a court to substitute its judgment for that of the Director."

In *National Labor Relations Board* v. *Hearst Publications, Inc.*, 322 U. S. 111, this court adopted the views advanced by the Department of Justice in its brief in that case and said, at pages 130 and 131:

> "Undoubtedly questions of statutory interpretation, especially when arising in the first instance in judicial proceedings, are for the courts to resolve, giving appropriate weight to the judgment of those whose special duty is to administer the questioned statute. *Norwegian Nitrogen Products Co.* v. *United States*, 288 U. S. 294, 77 L. ed. 796, 53 S. Ct. 350; *United States* v. *American Trucking Assos.*, 310 U. S. 534, 84 L. ed. 1345, 60 S. Ct. 1059. But where the question is one of specific application of a broad statutory term in a proceeding in which the agency administering the statute must determine it initially, the reviewing court's function is limited. Like the commissioner's determination under the Longshoremen's & Harbor Workers' Act, that a man is not a 'member of a crew' (*South Chicago Coal & Dock Co.* v. *Bassett*, 309 U. S. 251, 84 L. ed. 732, 60 S. Ct. 544) or that he was injured 'in the course of employment' (*Parker* v. *Motor Boat Sales*, 314 U. S. 244, 86 L. ed. 184, 62 S. Ct. 221) and the Federal Communications Commission's determination that one company is under the

'control' of another (*Rochester Teleph. Corp.* v. *United States*, 307 U. S. 125, 83 L. ed. 1147, 59 S. Ct. 754), the Board's determination that specific persons are 'employees' under this Act is to be accepted if it has 'warrant in the record' and a reasonable basis in law."

It is submitted the Tax Court's decision must be accepted on appeal "if it has warrant in the record and a reasonable basis in law" especially where the question at bar "is one of specific application and a broad statutory term" to a specific state of facts.

There being no controlling regulation and the construction of the Tax Court being a rational and plausible construction and no "strained or artificial construction of the statute" it must stand. Cf. *Helvering* v. *Reynolds*, 313 F. (2d) 428, 433; *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 349, dealing with departmental regulations. See also *Billings* v. *Truesdell*, 321 U. S. 542, 552, 553.

In *Williamsport Wire Rope Company* v. *United States*, 277 U. S. 550, this court held that the courts had no jurisdiction to consider questions of law arising under sections 327 and 328 of the Revenue Acts of 1918 and 1921. In *Blair* v. *Oesterlein Machine Co.*, 275 U. S. 220, it held the Tax Court had such jurisdiction. In *Duquesne Steel Foundry Co.* v. *Burnet*, 283 U. S. 799, and *Heiner* v. *Diamond Alkali Co.*, 288 U. S. 502, it held the circuit courts of appeal had no jurisdiction to consider questions of law arising out of the decision of the Tax Court in such cases. This decision could not have been put upon any express words of the statute conferring jurisdiction and must have been rested on the peculiar expert capacity of the Tax

Court. The contrary conclusion had been reached in *Ryan Car Co.* v. *Commissioner*, 44 F. (2d) 26, which points out that there are no statutory words supporting the decision finally made by this court.

The judicial code appears to give the circuit courts of appeal the same jurisdiction and authority to review cases arising in the courts of insular possessions as they have to review cases arising in our own district courts but, in *Decastro* v. *Board of Commissioners*, 322 U. S. ....., this court emphasized that where the question is one of local law, in which the local courts are especially competent, "to justify reversal in such cases, the error must be clear or manifest the interpretation must be inescapably wrong; the decision must be patently erroneous" and went to pains to explain the suggestion of the circuit court of appeals that this rule reduced it to function ministerially, was erroneous. See also the opinion of Mr. Justice Douglas in *Sancho Bonet Co.* v. *Texas Co.*, 308 U. S. 463.

In *Bates & Guild Co.* v. *Payne*, 194 U. S. 106, this court, reviewing a decision of the Postmaster General, said at pages 107, 108:

> "But we think that, although the question is largely one of law, determined by a comparison of the exhibit with the statute, there is some discretion left in the Postmaster General with respect to the classification of such publications as mail matter, and that the exercise of such discretion ought not to be interfered with unless the court be clearly of opinion that it was wrong."

Again this court said:

> "But there is another class of cases in which the rule is somewhat differently, and perhaps more broadly, stated, and that is, that where Congress has

committed to the head of a department certain duties requiring the exercise of judgment and discretion, his action thereon, whether it involve questions of law or fact, will not be reviewed by the courts unless he has exceeded his authority or this court should be of opinion that his action was clearly wrong."

So in the case at bar, the duty Congress has confided to the Tax Court is not a mere ministerial duty but one involving expert judgment and discretion. It did not intend this judgment to be exercised *de novo* on appeal.

After reviewing and quoting from the cases, this court further said, at page 109:

"The rule upon this subject may be summarized as follows: That where the decision of questions of fact is committed by Congress to the judgment and discretion of the head of a department, his decision thereon is conclusive; and even upon mixed questions of law and fact, or of law alone, his action will carry with it a strong presumption of correctness, and the courts will not ordinarily review it, although they may have power, and will occasionally exercise the right of so doing."

In conclusion this court said (p. 110):

"While, as already observed, the question is one of doubt, we think the decision of the Postmaster General, who is vested by Congress with the power to exercise his judgment and discretion in the matter, should be accepted as final."

That case also quoted from an earlier decision the expression in the *Dobson* case that to reverse, the courts must be able to identify a clear-cut mistake of law.

In his excellent article in 35 Harvard Law Review, Professor Albertsworth concludes, at page 149:

"As to the general principle governing judicial review to correct errors of law, it is submitted that, with improvement in the personnel of administrative bodies, decisions of law should come to be reviewed only if palpably erroneous."

Although, as an accounting question, the stock was substituted as a balance sheet liability for the bonds, we do not pitch our argument on the contention an accounting question is involved but on the broader principle that a body of lesser experts should rarely set aside the decision of greater experts and that the Circuit Courts cannot set aside the decision of the Tax Court on the "interpretation of the application of a statute to specific facts" unless it is not a rational application of the statute.

To make the Tax Court a mere agency to certify facts to the Circuit Courts of Appeal for determination of legal questions arising thereon will result in an unbreakable jam there. The whole federal judicial system will suffer the evils of long delay and may even break down. Uncertainty will cause the Tax Court to be flooded with appeals. Its maximum capacity to hear cases is about 1,158 a year (57 Harvard Law Review, p. 914, note 14). The Bureau, for the fiscal year ended June 30, 1943, found 298,475 income and profits tax deficiencies (note 13). The Tax Court also has estate and gift tax jurisdiction and renegotiation jurisdiction over war contracts, as well as jurisdiction to review section 722 cases.

The Ways and Means Committee report on the 1926 Revenue Act stated, "Appeals continue to be filed, averaging about 250 per week." Because of renegotiation, the Tax Court's jurisdiction has been greatly increased and war prosperity and high rates always bring a deluge of

tax cases.[2] As this court said in the *Dobson* case on page 494:

> "Increase of potential tax litigation due to more taxpayers and higher rates lends new importance to observance of statutory limitations on review of tax decisions."

We do not know the capacity of the various Circuit Courts of Appeal to decide cases but some indication of this is offered by the written opinions in the Federal Reporters. For example, 141 F. (2d) covers period from March 7 to April 12. If we count correctly, we find ten

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[2] The general counsel for the Treasury testifying before the Senate Finance Committee, at page 49 of the 1943 hearings, states as follows: "For many years it has been recognized that the volume and complexity of Federal tax cases require a specially qualified and skilled tribunal, such as the Tax Court, which shall devote its entire time and efforts to their consideration and disposition. This need threatens to become even more pressing after the war. The inevitable accumulation of cases during the war and the development of many excess-profits tax cases, particularly those arising under the general relief provisions of section 722, make it obvious that the Tax Court faces a possible post-war crisis, without the addition of complex renegotiation-of-contracts issues to its calendar."

In his letter to the chairman of the Finance Committee, the Presiding Judge of the Tax Court of the United States stated as follows with reference to the renegotiation jurisdiction, which the Revenue Act of 1943 conferred upon the Tax Court (p. 1112): "However, there is a strong probability that a great many cases will come here under the relief provisions of section 722. Broadening of the tax base may be expected to bring more. We also have a few processing-tax cases still to be disposed of. If, in addition, many cases come in under the renegotiation provisions, a serious tie-up of litigation may develop before this court."

opinions of the Fourth Circuit, twenty-two of the Seventh and forty-seven of the Second contained in this volume. Of, course, there will be a volume of other litigation on other Federal questions as well as litigation which always arises from business transactions in a period of prosperity.

While this litigation is going on and while tax questions remain unsettled, business transactions will be delayed. Often appeals are taken to various circuits in the hope of securing a conflicting decision and thus getting the case to this court. For example, the government appealed the question whether claims against an estate were limited to the probatable estate, to six different Circuit Courts of Appeal [88 F. (2d) 338 (C. C. A. 7th); 89 F. (2d) 69 (C. C. A. 5th); 89 F. (2d) 553 (C. C. A. 8th); 90 F. (2d) 745 (C. C. A. 1st); 94 F. (2d) 852 (C. C. A. 2nd) and 103 F. (2d) 1 (C. C. A. 6th)]. The first of these decisions was made February 26, 1937 and the last one was made March 13, 1939. For more than two years the settlement of all estates involving this question and the collection from them of the balance of the tax, which was not in dispute, was held up. In these appeals the respondent found two judges to agree with him in dissenting opinions.

As above noted, 57 Harvard Law Review says the capacity of the Tax Court is about 1158 decisions a year.

The Clerk of that court advises that in 1943 five-hundred-thirteen (513) decisions were appealed to the Circuit Courts of Appeal and to September 1, 1944, four-hundred-sixty-six (466) cases were appealed. Appeals are increasing. Almost half the cases decided are appealed. This is due, in part, to the belief that anything might be decided on appeal. Furthermore, every case appealed holds up the decision in a large number of other cases and other taxpayers

appeal to the Tax Court hoping some Circuit Court of Appeals may decide the issue favorably during the time their case remains on the docket.

At page 786 of his article on the *Dobson* case in 57 Harvard Law Review, page 783, Mr. Paul asserts "the cure may be worse than the disease" unless the circuit courts are given basic training in distinguishing law from fact. (The adoption of the rule, for which we contend as to review of legal questions, will certainly stem the tide of appellate litigation and remove the troublesome "law and fact" question). At page 798, he asserts a taxpayer may seek the Court of Claims or District Courts to get advantage of a broader appellate review. There is little to this. To do so, he would first have to pay the tax. Also, if he won, he would suffer delay while the government appealed. Taxpayers want matters settled properly and promptly and, if they have a good case, they want it decided by experts. Also, if they lose in the Court of Claims, they have small chance to get certiorari. At pages 803 to 808, he asserts there is no evidence in the committee reports the courts were not to have *carte blanche* to substitute their opinion for that of the Board on legal questions. This is true but it is likewise true there is no evidence in them that Congress did not intend they were not to reverse the Board on law questions unless it was patently wrong. The reports merely say the Courts "may consider the proper interpretation and application of the statute". Of course, no one questions this. Whether they may consider it *de novo* is the question. At pages 842 and 843, he suggests the Tax Court is different from other agencies and the Treasury may be the really expert administrative body. There is nothing to this so far as it touches the question at bar. Every important tax question comes before the Tax

Court for a ruling. Also, while the Treasury is expert, it acts contentiously in the capacity of tax gatherer and not impartially or judicially. It decides doubts in favor of greater revenue. See 18 of Atty. Gen. 246. Also, 53 Harvard Law Review, p. 1163. Only when an expert is impartial can he be trusted. Witness the sanity experts who swear on both sides in murder trials. Usually, when the "expertness" of the Revenue Bureau prevails in this court over that of the Tax Court, Congress has set aside this court's decision.[3] The *Kirby Lumber Company* case

[3] Note 422 on page 844 of Mr. Paul's article contains a collection of decisions of this court which he says the expertness of the Treasury prevailed over that of the Tax Court. The cases in this note support our argument. The *Southwest Consolidated Corporation* case, 315 U. S. 194, was set aside by Section 121 of the 1943 Act and the Tax Court's view established. This was also done in the *Brunn* case, 309 U. S. 461, by section 115 of the 1942 Act. As previously noted, both the *Kirby Lumber Co.* case and the *American Chicle* case, 291 U. S. 426, have been set aside.

Section 215 of the 1939 Act set aside *U. S. v. Hendler*, 303 U. S. 564. The following cases were also set aside by the 1942 Act: *Higgins*, 312 U. S. 212, by Section 121; *Enright*, 312 U. S. 636, by Section 134; *Taft*, 304 U. S. 351, by Section 406; *Crane Johnson Co.*, 311 U. S. 54, by Section 501; *Nemmolly Investment Co.*, 313 U. S. 584, by Section 503. Section 134 of the Revenue Act of 1943 set aside *Helvering v. Stuart*, 317 U. S. 154, and Section 502 modified *Estate of Sanford*, 308 U. S. 39. At least twenty other decisions of this court, which have been set aside, could be collected. The *Marr* case, 268 U. S. 536, resulted in the reorganization provisions (see Paul, "Studies in Federal Taxation, 2nd Series" page 4, note 4). Congress had to modify numerous other decisions which would extend this note to undue length to cite. At no time in the court's history have so many decisions on any subject been so promptly set aside by Congress as tax decisions made in the last five years.

is one example. Its "expertness" was recently manifested in its effort to tax stock dividends. He then points out (page 847) the Tax Court is not specially competent on questions of local law, which sometimes decide tax cases. This is true but, instances where local law does this, are so rare in the torrent of tax litigation as to be the exception rather than the rule. The tail cannot wag the dog. The same is true in cases where a common law definition decides a tax case. Also, if the Tax Court decides a local or common law question wrongly, this will be patent and obvious error and thus call for reversal. On page 850, he notes *Helvering* v. *Brunn*, 309 U. S. 461, failed to uphold the Tax Court but fails to note Congress set this court's decision aside by section 115 of the Revenue Act of 1942. He concludes (page 851) by suggesting this court will probably do as it pleases and infers that courts below should be excused for doing the same. We believe sound public policy prevails here over personal predilections.

As above pointed out, the Treasury acts contentiously in the capacity of a rapacious tax collector and not impartially like the Tax Court. Also, the regulations are *ex parte* and give no reasons. Therefore, more weight should be given to the Tax Court's interpretation of a statute than to a Treasury regulation. The Treasury has promulgated no regulation embracing the specific cancelation question in the case at bar. However, if it had promulgated one, saying there was no cancelation of debt where bonds were exchanged for stock, it is submitted such regulation would clearly be valid. Cf. *Textile Mills* v. *Commissioner*, 314 U. S. 326, 338; *Magruder* v. *Realty Corp.*, 316 U. S. 69, 73-74 and cases there cited. See note page 10 hereof. *A fortiori* the Tax Court's interpretation is valid. As said of section 270 by Mr. Paul in his article entitled

"Debt and Basis Reduction" in 15 Tulane Law Review 1, at page 14: "It would be an understatement to call this provision a masterpiece of ambiguity." The requisites of a valid regulations are: (1) that the statute be ambiguous, *Iselin* v. *United States*, 278 U. S. 280; (2) that it be capable of the construction given it, *Dollar Savings Bank* v. *United States*, 19 Wall. 227, 237, and (3) that the construction given it be reasonable, *Brewster* v. *Gage*, 280 U. S. 336. All these reasons operate to sustain the decision of the Tax Court in the case at bar.

Nor is it enough to reverse the Tax Court that the reviewing court, if trying the case *de novo* below, might on the same record have arrived at different conclusions. In *Federal Security Admr.* v. *Quaker Oats Co.*, 318 U. S. 218, this court said, at pages 227 and 228:

> "The review provisions were patterned after those by which Congress has provided for the review of 'quasijudicial' orders of the Federal Trade Commission and other agencies, which we have many times had occasion to construe. Under such provisions we have repeatedly emphasized the scope that must be allowed to the discretion and informed judgment of an expert administrative body. (Citing Cases). These considerations are especially appropriate where the review is of regulations of general application adopted by an administrative agency under its rule-making power in carrying out the policy of a statute with whose enforcement it is charged. (Citing Cases). Section 401, 26 USCA § 341, calls for the exercise of the 'judgment of the Administrator.' That judgment, if based on substantial evidence of record, and if within statutory and constitutional limitations, is controlling *even though the reviewing court might on the same record have arrived at a different conclusion.*" (Italics ours.)

Judicial review of an administrative agency's interpretation of a statute in its application to a specific state of facts (we are not here referring to constitutional or jurisdictional questions or procedural safeguards) does not involve, on the one hand, on the part of the appellate court, a determination de novo or an original determination as if the question had arisen before it in the first instance. On the other hand, the interpretation of the statute by the administrative agency is not conclusive. The scope of Judicial review of the interpretation and application of the statute by the administrative agency rests in a middle ground between these two extremes. That ground may be stated in the form of a rule that, if the construction and application of the statute by the long and widely experiences and highly specialized administrative agency is a reasonable and plausible one and not plainly and beyond reasonable doubt contrary to the terms of the statute, then another interpretation cannot be substituted by the appellate court albeit the appellate court can think of a more reasonable interpretation and albeit it would have construed and applied the statute differently had the same facts come before it as an original trial body.

The reason for this rule is found in the expertness of the Tax Court. It is better staffed and better qualified to decide questions of tax law than most of the Circuit Courts of Appeal. Even this court's decisions on tax questions have at times created chaotic confusion and, on page 29 hereof, is a list of some of them set aside by Congress.

To give the Circuit Courts *carte blanche* to substitute their opinion for that of the Tax Court will eventually result in taking away from the courts all jurisdiction to review it and vesting it in special courts created for this purpose composed of experts. (See testimony of the author of this

brief before the Senate Finance Committee, 1941 Hearings, pages 235 to 237.)

These administrative agencies are not especially expert in fact finding. Their real expertness is in the law they administer. They know its history, the reasons for it and they have the indispensable broad view of its relation to and impact on related questions, which the courts of appeal do not have.

Landis, in "The Administrative Processes," at page 144 says:

> "The interesting problem as to the future of judicial review over administrative action is the extent to which the Judges will withdraw, not from reviewing findings of fact, but conclusions upon law. If the withdrawal is due to the belief that these issues of fact are best handled by experts, a similar impulse to withdraw should become manifest in the field of law."

At page 152, he points out the reason the people desire questions of law determined by courts is only to give them the benefit of the opinion of experts. Here the Tax Court is generally more expert than the Circuit Courts of Appeal. In 47 Yale Law Journal, on page 597, the author concludes:

> "The courts should not be permitted to search for the correct interpretation of a statute, after an administrative agency has attempted to make such a determination, but should merely inquire as to the reasonableness of the particular determination which has been made."

At page 596 he points out some consequences of the contrary rule.

The foregoing is quoted with approval in the article in

9 George Washington Law Review, page 514. The Court's attention is directed to the exhaustive note in 56 Harvard Law Review, at page 100.

Consider the present situation. The members of the Tax Court, with twenty and thirty years' experience specializing in tax law, consider the facts in a tax case and apply the law to it. An appeal is taken to the Circuit Court of Appeals. A judge, who was a friend of one of the Senators, has just been appointed to that court. His entire experience has been sitting on the bench in a local court in the rural section of Wyoming. He never considered a Federal tax case. One comes before the court for decision. The judges hear the argument and then it is assigned to him to study and write an opinion. He studies the case, writes an opinion and sends it around to the other judges to sign. Sometimes they sign it without reading it. It is then handed down as the decision of the court. A novice substitutes his opinion for an expert's. No wonder there is confusion in tax law. Even if the Tax Court knows a decision is wrong it is influenced by it. In *Commissioner* v. *Heininger*, 320 U. S. 467, this court observed that the Tax Court was coerced into error by an erroneous decision of the Circuit Court of Appeals. The same thing has happened in many cases.

II.

Considered as an Original Proposition, the Decision of the Tax Court that the Bonds Were Not "Canceled" by Their Exchange for Stock Is Correct.

The argument under this heading is addressed to this Court as if each of its justices were sitting at a trial *de novo* and trying the case as a matter of first impression.

The first rule of statutory construction is that words are to be given their ordinary meaning and taken as the average citizen would understand them. *Avery* v. *Commissioner*, 292 U. S. 210, 214, and *Addison* v. *Holly Hill Fruit Producers, Inc.*, 322 U. S. .....

As stated in the article on section 270 of the statute in 53 Harvard Law Review, at page 1009: "In popular parlance no one would ordinarily use the words canceled or reduced in speaking, for example, of conversion of debt into stock in a purely capital transaction." Note Tax Court's reasoning in *Capento Securities Co.*, 47 B. T. A. at p. 695. Cf. *Alcazar Hotel, Inc.*, 1 T. C. 872.

Under state statutes, a will may be revoked by canceling it. When it is canceled, its legatees take nothing. Here the creditors took substantially the entire property of the debtor in satisfaction of their bonds.[1] If they had been canceled, it would not have been necessary to give them anything and the old corporation could have gone on its way free of debt.

In *Helvering* v. *Stockholms Enskilda Bank*, 293 U. S. 84, it is stated:

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[1] *In re Kutzner's Will*, 19 N. Y. S. (2d) 13, 16, the court said:

"The word 'cancel' is derived from the word 'cancelli', crossbars or latticework. Hence as originally used it referred to making cross lines on writing. • • • There is no doubt that originally the word 'cancel' was confined to the making of cross marks indicating the latticework from which it was derived and grew to be adopted for such purposes in consequence of the fact that in early times few people were capable of writing and therefore were permitted to manifest their intent by drawing lines across the face of the paper."

> "* * * the intent of the lawmaker controls in the construction of taxing acts as it does in the construction of other statutes, and that intent is to be ascertained, not by taking the word or clause in question from its setting and viewing it apart, but by considering it in connection with the context, the general purpose of the statute in which it is found, the occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will. * * *"

The Tax Court in its opinion in the case at bar concededly correctly stated "Section 268 is an obviously legislative effort to release 77 B reorganizations from the tax burden of the *Kirby Case*, and since Section 270 is manifestly *in pari materia* with it; we have to consider whether this is the sort of situation to which either section was intended to apply." Cf. *Helvering* v. *American Dental Co.*, 318 U. S. p. 328, and articles cited in note 8 therein.

Kirby Lumber Co. v. *United States*, 284 U. S. 1, in which this court sustained the Treasury decision and reversed numerous holdings of Tax Court, is an example of the evils which will result when expert judgment is set aside. That decision of this Court has now been repealed and set aside by Congress, in the words of the committee, to remove a "business deterrent and tax irritant." (Sec. 114, 1942 Act.) 49 Yale L. J. 1153; 53 Harvard L. S. 977.

The court below (R. 233) purported to "search for the intent of Congress." Such intent is always found in the proceedings of Congress but it is doubtful if the court below ever looked at the legislative hearings or committee reports. Instead, it merely imagined what the intent of Congress was, as its opinion (R. 233) discloses.

The error of its reasoning is stated in the brief in support of the petition for the writ, at pages 15 to 18, and is not repeated here. The reasoning discloses complete ignorance of the theory of depreciation in tax law and also of the effect of a tax free corporate reorganization.

The history of the legislation discloses the intent of Congress was:

(1) To relieve debtors from tax, if income arose from the forgiveness of debt, and

(2) If debtors were relieved of tax, to reduce the basis by such amount.

The Legislative Hearings.

Bankrupts were apprehensive that under the *Kirby Lumber case* the forgiveness or reduction of debt would charge them with a big income tax, which they might be unable to pay. (For complete history see Paul "Debt and Basis Reduction." 15 Tulane Law Review, page 1.)

Section 268 arose from the suggestion of Mr. Banks, member of the National Bankruptcy Committee (see judiciary committee hearings on the revision of the Bankruptcy Act., 75th Congress, 1st Session, pages 266 to 268).

Section 268, as originally contained in the house bill, read: "No income or profit * * * shall be deemed * * * to have been realized * * * by reason of a modification in whole or in part of any indebtedness" (Report House Judiciary Committee, July 29, 1937, p. 114.) There was no provision for basis reduction.

Section 270 arose from the suggestion of Mr. Kent, As-

sistant Chief Counsel of the Treasury, who testified as follows at pages 353 to 354:

> "Moreover, we feel that if this remedial provision is written into the law, it should be connected up with a provision for the reduction of the basis of the assets of the debtor to the extent that Congress refrain from taxing income which it would be entitled, under the law, to tax.
>
> "Let me give one or two illustrations to show you how it would operate: Suppose a corporation has been formed for the purpose of putting over real-estate subdivisions. It bought a piece of property at a contract sale price of $1,000,000. It has paid $250,000 on that $1,000,000, and then it gets in trouble and has to reorganize. As a result of that reorganization the indebtedness of that property is written down by the vendor from $750,000 to $500,000. Having reorganized, and conditions having improved, the corporation goes on and is able to sell its subdivision on a profitable basis. Now, under this provision as now written in the bill, the Bureau of Internal Revnue would be precluded from asserting any income-tax liability by reason of the $250,000 cancellation of indebtedness in the reorganization proceeding. Yet, isn't it perfectly apparent that all that the corporation paid for its property, assuming that in due course the $500,000 is paid off, is $750,000; and if it markets the property for $1,500,000, its profit is $750,000 less expenses, and not $500,000 less expenses.
>
> "The draft which the Treasury Department is submitting for your consideration would make the basis in such a case $750,000.
>
> "That seems to us to be the most fair and equitable solution; both from the point of view of revenue and from the point of view of the taxpayer, it is possible to work out."

The foregoing plainly shows that the Treasury was considering a case of forgiveness of debt and not a case of

exchange of stock for bonds. It harmonizes with our construction of the statute on page 39 hereof.

The Committee Reports.

The committee reports likewise sustain the contention that only cases of forgiveness of debt, excluded from tax by Section 268, were embraced within the section. Senate Report No. 1916; 75th Congress, page 7, states:

> "20. Income-tax exemptions. (Sec. 268, p. 176.) The Committee has adopted revised language as submitted by the Treasury Department, precluding tax assessments resulting from the scaling of indebtedness on the basis of a write down in the valuation of a debtor's assets, without an actual sale or exchange of such assets. Such an exemption is in accordance with the fundamental objective of debt readjustment."
>
> "21. Basis of property. (Sec. 270, p. 177.) This provision is intended to prevent a double deduction. Where *debt forgiveness* resulting from a debt readjustment *is exempt from tax* upon income or profit, the cost of the property dealt with by the settlement is to be decreased *for future tax purposes*, by an amount equal to the amount of the indebtedness canceled or reduced in the proceeding." (Italics ours.)

The Senate Judiciary Committee report also reads as follows (S. Rep. No. 1916, 75th Cong., 3d Sess., p. 39):

> "Sections 268, 269, and 270 are intended to preclude tax assessments resulting from the scaling of indebtedness on the basis of a write-down in the valuation of a debtor's assets, without an actual sale or exchange of such assets. Section 270 avoids the possibility of any double deduction. *Where debt foregiveness, resulting from a debt readjustment*, is exempt from tax upon income or profit, the cost of the property dealt with by the settlement is to be decreased, *for future tax purposes*, by an amount equal to the amount of the indebtedness canceled or reduced in the proceeding." (Italics ours.)

The foregoing plainly and bluntly states that where forgiveness of debt is excluded from tax by section 268, section 270 is intended to reduce the basis of property by the amount thus excluded. Also section 276 (c) (3) (page 56) considers sections 268 and 270 to be interdependent. (The Court below considered them together. See R. 234, 235.) Note the words "for future tax purposes."

When the 1940 amendment was under consideration, it was proposed that it provide the basis be only reduced by the amount freed from tax by section 268. However, in some cases indebtedness had been reduced by so many millions (the tax status of which was in doubt under the *Kirby case*) that such a provision would leave some corporations with a zero base. They objected to it and demanded instead, a provision that the reduction not go beyond market value. This was adopted.

In the case at bar, there is no amount thus excluded from taxable income. The Tax Court found that the transaction was a non-taxable reorganization and respondent accepts that conclusion. The bondholders were unable to deduct any loss (section 112 (b) (3) I.R.C.) (*Burnham* v. *Commissioner*, 86 F. (2d) 776, cer. den. 300 U. S. 683, and *Helvering* v. *Cement Investors*, 316 U. S. 527) and neither corporation realized either income or loss (112 (b) 4). See note in 87 L. ed. page 817, 818, *Hummell-Ross Fibre Co.* v. *Commissioner*, 46 B.T.A. 821. Why would Congress impose the burden of section 270 on a bankrupt when it had no benefit from sec. 268?

The court below construed the statute to mean that the basis was to be reduced by the amount of debt reduction excluded from tax by section 268 but erroneously assumed

that Section 268 excluded from tax what otherwise would have been taxable income (R. 236). (See our brief in support of petition, p. 16.) It said: "We are relieving an involved debtor from an income tax" (R. 236). It erred because it did not know that no tax arose where the transaction fell within the Revenue Act's definition of reorganization as it did here.

Departmental Interpretation.

The regulation of the Treasury (Appendix) does not define debt cancelation and is of no assistance in solving the question at bar. This court has repeatedly decided that rulings of the Treasury, which are not regulations, do not have the weight of regulations. *Helvering* v. *New York Trust Co.*, 29 U. S. 455, 468; *Biddle* v. *Commissioner*, 302 U. S. 573, 582. Also, on whether debt is canceled in a transaction such as this, the Bureau ruled the other way closer to the date section 270 was enacted.

In the spring of 1938, the question arose as to whether, under the proposed plan of reorganization, a Boston Trust would realize a profit from the surrender of all the bonds of the taxpayer in exchange for its stock. This question held up the confirmation of the plan until it could be answered. An attorney from Boston wrote the Commissioner for a ruling on March 2, 1938. On May 13, after a lapse of seventy days, he received a careful and considered answer from the Commissioner which bears evidence of close and painstaking analysis of the question propounded, and is set forth in the appendix B hereof at page 59. The Commissioner stated:

> "Under the facts presented, and as above outlined, it does not appear that there is involved in the plan any question of the cancellation of indebtedness. In

each instance with the exception hereinafter noted where an indebtedness of the corporation is involved, and is being extinguished it is to be effected through an exchange and a payment of the indebtedness rather than through cancellation of the indebtedness, the consideration being the exchange of its new convertible preferred shares and common shares for its first and second mortgage bonds, and the accrued interest thereon. The same situation exists with respect to the satisfaction of the unpaid compensation due trustees which had accrued prior to January 1, 1933. The trustees accept the common stock in payment and discharge of their claim. It is, therefore, the opinion of this office that no taxable income will be realized by the taxpayer by reason of these transactions."

In reliance on the above ruling, the Substitute Plan of Reorganization was promptly confirmed and carried out in full.

In 1941 the Bureau published G.C.M. 22528, C.B. 1941-1, at page 193, in which it expressed the opinion that the law was as contended by respondent here and as held by the court below and contrary to the above ruling.

This expression of the opinion falls within the class of rulings considered in the two decisions of this court last above cited. It is an example of rulings which this Court, in the cases cited at page 35 hereof, holds entitled to little weight.

When the Revenue Act of 1943 was under consideration, taxpayers emphatically protested the Commissioner's construction and that of the court below to Congress and, in Section 131 (c) (3) and (e), Congress repealed Section 270 but such repeal operates prospectively only. In his speech on the presidential veto, Senator Barclay stated that

whether the repeal would mean anything would depend on the outcome of the cases now in the courts. Repeal may have been unnecessary but it was made out of an abundance of caution. In other words, a Congress composed of a majority of the same men who composed the Congress which enacted section 270 recognized the injustice of respondent's contention and nullified it. This shows Congress did not have the intention imagined by the Circuit Court of Appeals in the decision below.

By section 215 of the Revenue Act of 1939, c. 247, 53 Stat. 862, Congress adopted somewhat similar provisions to apply to corporations (other than those in bankruptcy) in "unsound financial condition." *Helvering* v. *American Dental Co.*, 318 U. S. at p. 329.

The Committee report explained section 22 (b) as follows (for report see C. B. 1939-2, p. 522):

> "The new paragraph provides that the amount of income of a corporate taxpayer attributable to the discharge within the taxable year of its indebtedness or indebtedness for which it is liable (as, for example, in the case of a debt arising from an assumption of liability of another corporation) is to be excluded from gross income, provided (1) the Commissioner is satisfied that such taxpayer was at the time of such discharge in an unsound financial condition and (2) such taxpayer consents to regulations prescribed under the new section 113 (b) 3 of the Code, relating to reduction of basis in effect at the time of the filing of the return."

It explains section 13 (b) (3) as follows:

> "As a corollary to the amendment made by subsection (a), subsection (b) adds a new paragraph (3) to section 113 (b) of the Internal Revenue Code, relating to the adjusted basis of property. The new

paragraph provides that *if an amount is excluded from gross income of a corporate taxpayer under the amendment made by subsection (a)*, the basis of the taxpayer's property held by it at any time during the taxable year in which a discharge of indebtedness occurred shall be subject to reduction." (Italics ours.)

This court will observe it applies to corporations not in bankruptcy and the basis was to be reduced only in cases where debt reduction resulted in income which would otherwise be taxable except for the provision exempting it and it was optional with a taxpayer whether to avail itself of the exclusion provision. If it did not elect to do so the basis provision did not apply. In other words the reduction was limited to income excluded by the section from tax.

The Ways & Means Committee report, however, stated:

"Wherever a discharge of indebtedness is accomplished by the transfer by the debtor of property in kind, such as by the issue of its own stock, the difference between the amount of the obligation discharged and the value of the property transferred is the amount which may be excluded from gross income and applied in reduction of basis."

The court will note the Judiciary Committee and not the Ways & Means Committee was in charge of the legistion involved in the case at bar. No decision has ever held the report of a committee not in charge of a bill and addressed to a different bill is a competent on the construction of a bill to which it was not addressed and does not refer. The Committee report stated of the amendments: "They likewise do not apply to any discharge of corporate indebtedness occurring in any proceeding under section 77 B" (or under the Chandler Act) 'since such

discharges are governed by other provisions of law." See *Helvering* v. *American Dental Co.*, 322 U.S. p. 329. There is no evidence the Senate Finance Committee thought this Act meant what the Ways & Means report stated. (For Senate Report see C.B. 1939-2, p. 527.) There was no conference report on this act.

Of course, the case at bar is not within the above example because this taxpayer was not the debtor and the example refers to an issue by the debtor "of its own stock." Furthermore, such case would usually not come within the 1939 amendment at all because such issue would usually be in connection with a recapitalization, which is a tax free reorganization. (*Capento Securities Co.*, 140 F. (2d) 382, and *Hoagland Co.*, 121 F. (2d) 962, and many other cases.) In such case there is no income to exclude from tax by Section 22 and the 1939 basis amendment is not applicable. Had what was done in the case at bar been done outside 77B, this 1939 amendment would not touch the case. Taxpayer should be in no worse position merely because it was done under 77B.

Meaning of the Words "Canceled or Reduced."

A cancellation occurs when an indebtedness is not accorded recognition in a plan of reorganization and a reduction occurs only when the indebtedness is accorded recognition in a reduced amount. Where recognized to the extent of its full amount the debt has not been "reduced or cancelled' regardless of the nature of the provisions with respect thereto. No question of reduction is here.

In virtually every reorganization the value of the property is less than the face amount of debt yet the full amount of the senior debt is recognized by issue of stock and the

junior debt canceled. Also, in most large reorganizations, secondary bond or note issues were canceled and not recognized. The value of the property and the actual value of the senior debt are the same in cases where the debt accorded recognition takes the entire property.

In cases where the value of the property is not in excess of the first lien debt, no provision for secondary debt is made and it is thereby canceled. If the value of the property exceeds the first lien debt, but doesn't equal the junior debt, the second debt is often recognized only in part.

If Congress had intended that debt fully recognized in a reorganization and exchange for stock be considered "cancelled or reduced" it could have precisely said so, leaving no room for doubt and uncertainty. The Committee reports on page 33 hereof, show it had in mind forgiven debt.

Furthermore, the hearings and committee reports show beyond doubt the purpose of the statute was to compensate the Treasury for tax lost by section 268 and, if there was no tax so lost, there was to be no reduction in basis. Even if the statutory words were to the contrary (which they are not), this court has often "followed the purpose rather than the literal words." *Trucking Associations*, 310 U. S. 541, 543, 544, and *United States* v. *Rosenblum Truck Lines*, 315 U. S. 50, 55. The same purpose is found in the basis income tax amendment discussed at page 38 hereof which beyond dispute only applies where income is freed from tax.

While there might have been a court reorganization under section 77 B out of which taxable income and tax consequences arose to all concerned (Cf. *Helvering* v. *South-*

west Consolidated Co., 315 U. S. 194) the Tax Court held this a tax free reorganization and consequently there was nothing for section 268 to free from tax. The Tax Court said (R. 197):

> "Both gain or loss and depreciation to the new corporation can appropriately be measured by the old basis without doing violence either to the tax consequences of the reorganization or to the doctrines upon which those consequences rest."

The court below failed to appreciate this and both this taxpayer and "the tax system suffers from the lack of a roundly tax informed viewpoint of the Judges." *Dobson case*, p. 500. They overlooked both the theory of depreciation and the reorganization provisions.

When it is considered the purpose of the bankrupt law is to help the bankrupt get a fresh start and not to give its solvent competitors an advantage, surely Congress did not intend to burden it with the heavy burden of section 270 when it had no benefit from section 268. The decision of the court below accepted this reasoning but, because it apparently did not know the tax consequences of a reorganization, it erroneously said section 268 relieved the debtor from a tax. (See quotation in brief in support of petition for writ, p. 16.)

In *Helvering* v. *Cement Investors*, 316 U. S. 527, this court said, at p. 532:

> 'The ownership of the equity in these debtor companies effectively passed to these creditors at least when 77 B proceedings were instituted.'"

Here the ownership of the corporate assets passed to the bondholders on October 1, 1931. From that date their

bonds were evidence of their ownership. On May 14, 1935, they exchanged these bonds for corporate stock—another evidence of ownership of the same assets. This exchange was a non-taxable transaction. *Burnham* v. *Commisioner*, 86 F. (2d) 776, cer. den. 300 U. S. 683; *Helvering* v. *Cement Investors;* 316 U. S. 527. Every cash dollar which the debtor had secured for these bonds to build the apartment building was still in it. It was hard cash not "make believe water values." The cost of the building remained unchanged for tax purposes because, in a reorganization, the transferor's basis carries over to the transferee. *Palm Springs Holding Co.* v. *Helvering*, 315 U. S. 185. It is obvious from the opinion of the court below that it thinks depreciation is based on the present market values whereas it is based on the cost. (See page 11, petition for the writ herein.) During the depression, most values were below cost. The theory is, recovery of cost is not income.

In a case where a solvent corporation exchanged stock for bonds (different from the case here because bonds in a solvent corporation do not represent equitable ownership of its assets) the court below, in an opinion by the same Judge (*Chicago, Rock Island & Pacific Ry. Co.* v. *Commissioner*, 47 F. (2d) 990, cer. den. 384 U. S. 618) said at 47 F. (2d), page 992:

> "Had petitioner paid off its bonds in cash at par, a loss would have occurred. Instead of paying off these bonds in cash, however, petitioner issued its stock to retire them. The stock was not worth par any more than the bonds were worth par. Petitioner's bonds were a liability. So was its capital stock. It exchanged one liability for the other. Presumably they were of the same value." See 40 Col. Law R. p. 1336.

Consequences of Upholding the Construction Adopted by the Court Below.

Consider the absurd consequences of the decision below. You invest $500,000. in all the bonds of a corporation and it builds an apartment house with this $500,000. Values shrink in a depression and you exchange your bonds for stock worth $100,000. at market but, the transaction being a non-taxable reorganization, neither you nor the old or new corporation realizes any profit or loss. A boom time comes and the new corporation sells the building for cost less depreciation, say for $350,000. Under the holding of the court below, it has a taxable profit of $250,000. You can never recover your investment. The effect is to tax the capital invested by you as income. It is submitted Congress never intended such absurd results. It never proposed to turn an income tax into a capital levy. The situation it sought to reach is the one contained in the example given by Kent and quoted at page 32 hereof. Furthermore, the construction of the court below creates an indefensible discrimination between 77 B and other reorganizations. Under this construction, when the plan was confirmed in 1935 and final decree entered March 1, 1937, the corporation was unquestionably entitled to use its predecessor's base but according to respondent Congress later imposed a retroactive burden on former bankrupts not imposed on rich corporations reshuffling their capital structure by an identical substitution of stock for bonds. In the words of this court in *Miller* v. *Nat Margarine Co.*, 284 U. S. 489, 510, "such discrimination conflicts with the principle underlying the constitutional provision directing that excises laid by Congress shall be uniform throughout the United States."

Also, no reason, rational or irrational, can be suggested why Congress should have wanted to do any such thing.

As Mr. Paul points out in his article in 15 Tulane Law Review, at page 7, Mr. Chandler, who was in charge of the bill, thought section 270 only reduced the basis to the extent income was relieved of tax by section 268 and blamed the confusion on the Treasury.*

The statement of the court below that capital stock is not a debt is another straw man and false issue wholly immaterial to any question here presented. No one ever asserted it was a debt. The Tax Court was correct in terming it a liability. *Helvering* v. *Canfield*, 291 U. S. 166, wherein this court said surplus is "the amount of net assets over liabilities including capital stock." The word "liability" is much broader than the word debt. Capital stock represents the liability of the issuing corporation to its shareholders. It owes them everything.

The decision below not only puts a burden on bankrupts not put upon solvent corporations exchanging stock for bonds but makes it necessary to make an administrative valuation in every bankruptcy case (of no use after 1943 because of the repeal of section 270 by the 1943 Act) and also an allocation of the debt to different items of depreciable property having different rates of depreciation and thus sews the seeds of litigation in every such case.

Section 270 Is Not Retroactive So as to Effect Tax Liability Prior to the Year of Its Enactment.

The words of the Statute, relied on by respondent, are (Appendix 56, 57):

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*This article by Mr. Paul is a later and more seasoned consideration of the question than appears in *Studies In Federal Taxation* (3rd series) at pages 147 to 156.

"(3) sections 268 and 270 of this Act shall apply to any plan confirmed under section 77B before the effective date of this amendatory Act and to any plan which may be confirmed under section 77B on and after such effective date."

The court below, reversing the Tax Court, quotes these words in its opinion and states:

"Given their ordinary meaning the words 'before the effective date of this amendatory Act' mean that it, the Act, applies to reorganizations which were completed before June 22, 1938."

In so holding the court below decided a false issue not in dispute and not an answer to this issue. Also, the statute does not refer to "reorganizations completed" but to "plans confirmed". They are often confirmed long before reorganizations are completed.

Of course, the Act applies to 77B plans confirmed before its enactment. Everyone admits that and it was not even an issue in this case. (At page 47 we raise the issue whether such confirmed plans must have been in cases pending when it was enacted.) The question under this heading is not whether it applies to plans already confirmed. Assuming it does, the question is whether it applies to such plans for past tax years? The court below missed the point that this was the question.

The decision of the Tax Court in this case was that it applied to this plan although confirmed before the Act was passed. That is the most anyone can read the Act to say. It does not say it applies retroactively in computing tax liability or that it applies in computing the tax liability for years prior to the year of its enactment. At most, it says

that from the year of its enactment it applies in computing tax liability of "any plan confirmed before the effective date of this amendatory Act". (Whether the Statute limits this to pending cases is discussed on page 47 hereof.)

A reading of the opinion of the court below discloses it does not touch this issue. It decides a false issue—a point conceded by all and assumes it determines the case.

In a very carefully considered opinion in *The Commodore*, 46 B.T.A. 717, at page 723, the Board of Tax Appeals quoted the report of the Senate Judiciary Committee that section 270 applies "for future tax purposes" and so held, as it also held in the case at bar. The Board was affirmed in *The Commodore* case by the Sixth Circuit in 135 F. (2d) 89, which also relies on the committee report.

Apparently the learned court below, when it "searches for the intent of Congress" (R. 233) does not look at committee reports. As this court observed in *American Dental Co.*, 318 U. S. 322, at page 329, the related income tax provision discussed at page 37 hereof, was not retroactive. Why would Congress want to make this retroactive?

Rules of construction here applicable have been stated by this court as follows:

In *Schwab* v. *Doyle*, 258 U. S. 529, this court, at page 534, quoted Justice Story as follows:

> "Retrospective laws are, indeed, generally unjust; and as has been forcibly stated, neither in accord with sound legislation nor with the fundamental principles of the social compact."

In *Union Pacific Railroad Co.* v. *Laramie Stock Yards Co.*, 231 U. S. 190, the court said, at page 199:

"Construction, therefore, becomes necessary, and the first rule of construction is that legislation must be considered as addressed to the future, not to the past. The rule is one of obvious justice, and prevents the assigning of a quality or effect to acts or conduct which they did not have or did not contemplate when they were performed. The rule has been expressed in varying degrees of strength, but always of one import, that a retrospective operation will not be given to a statute which interferes with antecedent rights, or by which human action is regulated, unless such be 'the unequivocal and inflexible import of the terms, and the manifest intention of the legislature'. (Citing cases.)"

Every presumption is indulged against retroactive construction and an act will be so construed only when there is no reasonable escape from such construction.

Congress has never imposed additional taxes retroactively as far back as five years past unless it has done so in this instance and there is a constitutional doubt whether it can do so, yet respondent asks the court to construe the act as imposing a retroactive tax on Federal bankrupts not imposed on any other corporation. It is submitted this would be an absurd construction.

Section 270 Does Not Apply to Proceedings Not Pending When It Was Enacted Because Final Decrees Had Been Entered Long Prior Thereto.

The Tax Court did not decide the question we raise here and it is necessary to decide it because of the holding below on the interest cancelation.

In the case at bar the plan was confirmed under section 77B, May 14, 1935 (R. 187) and the final decree was entered March 1, 1937 (R. 187). The Chandler Act was enacted

June 22, 1938 and became law September 22, 1938. The report of the Senate Judiciary Committee states on page 39 thereof:

> "Article XVI. When Chapter Takes Effect.—Section 276 keeps section 77 B operative, except as noted below, with respect to proceedings pending when this chapter takes effect. This chapter is made applicable in its entirety to proceedings in which the petition was approved not more than three months before this chapter becomes effective. In these cases, the courts and the parties have ample notice of the provisions of this chapter since the Act does not take effect until three months after it is signed."

In all legislation the problem arises to what extent it shall be applied in pending proceedings. The legislature does not usually consider its application to cases long closed by final decree.

Section 270, read by itself, does not apply to any proceeding except "a proceeding under this chapter", i.e. Chapter X added by the Chandler Act. (See 46 B.T.A. at p. 723.) By itself, it does not apply to this 77B proceeding.

If it applies to proceedings under section 77B, long since closed by final decree, such application must clearly be spelled out of the following language of the statute:

> "Section 276.
>
> "(c) the provisions of section 77A and 77B of chapter VIII, as amended, of the Act entitled 'An Act to establish a uniform system of bankruptcy throughout the United States', approved July 1, 1898, shall continue in full force and effect with respect to proceedings pending under those sections upon the effective date of this amendatory Act, except that—
>
> "(1) if the petition in such proceedings was approved within three months prior to the effective date

of this amendatory Act, the provisions of this chapter shall apply in their entirety to such proceedings; and

"(2) if the petition in such proceeding was approved more than three months before the effective date of this amendatory Act, the provisions of this chapter shall apply to such proceedings to the extent that the judge shall deem their application practicable; and

"(3) sections 268 and 270 of this Act shall apply to any plan confirmed under section 77 B before the effective date of this amendatory Act and to any plan which may be confirmed under section 77 B on and after such effective date, except that the exemption provided by section 268 of this Act may be disallowed if it shall be made to appear that any such plan had, for one of its principal purposes the avoidance of income taxes, and except further that where such plan has not been confirmed on and after such effective date, section 269 of this Act shall apply where practicable and expedient." (U. S. C. 1940 ed., Title ii, Sec. 676.)

It is submitted the above statute refers in the first paragraph of (c) above "to proceedings pending" under 77B and that exceptions (1), (2) and (3) are keyed into this first paragraph and refer to pending proceedings also. They merely except from the *pending cases* those to which 77B is not to apply. Since (c) deals only with pending cases and not closed cases, they refer also to pending cases.

If a plan had been already confirmed in a pending proceeding, it could be vacated (Sec. 77B, subdivision (f)) and reformed so as to be framed in the light of section 270 and make it comply with the provision of the Act that it be fair to all parties and feasible. Also, any case closed in 1934, would have been closed without benefit of section 268, taxes paid and claims for refund barred. Since Congress intended neither section should apply except where the other

did, it could not have intended section 270 to apply to such plan.

The crucial statutory language is section 77B shall apply "with respect to proceedings pending, except." Therefore, these exceptions to which the Chandler Act applies are only talking about pending cases.

CONCLUSION.

The decisions of the Tax Court on the interpretation and application of a statute to specific facts are not conclusive. On the other hand, that court has not been vested by Congress only with the duty of finding facts and certifying them to Circuit Courts of Appeal to have the legal questions arising thereon determined therein *de novo*. Congress provided the Tax Court should decide legal questions arising on the facts. The Ways & Means Committee, in its report on the 1926 Act, referred to the Tax Court members as "experts in the field of tax law."

In providing the Courts of Appeal might reverse the Tax Court decision where it was "not in accordance with law", Congress obviously intended it must be so palpably and beyond doubt. This is implicit in the appellate procedure. If the decision of the Tax Court rests on a rational basis it must be sustained. The reason provision is made for the decision of questions of law by judges is solely that they may be determined by experts. The average Tax Court Judge is a greater expert in tax law than the average Judge of a Circuit Court of Appeals. The opinion of the Court of Appeals in the case at bar is one more exhibit offered to prove this assertion. The 1926 Ways &

Means Committee report also states: "The Committee is of the opinion that the great value of the Board lies in its practice of meeting regularly for common consideration and discussion of opinions prepared and proposed to be issued." It has sixteen pages.

If this court should declare the rule for which we contend, we fear lip service only will be given it below unless it is emphasized by language such as found in *Sancho Bonet Co.* v. *Texas Co.*, 308 U. S. 463, where this court said at page 471:

> "We now repeat once more that admonition. And we add that mere lip service to that rule is not enough. To reverse a judgment of a Puerto Rican tribunal on such a local matter as the interpretation of an act of the local legislature, it would not be sufficient if we or the Circuit Court of Appeals merely disagree with that interpretation. Nor would it be enough that the Puerto Rican tribunal chose what might seem, on appeal, to be the less reasonable of two possible interpretations. And such judgment of reversal would not be sustained here even though we felt that of several possible interpretations that of the Circuit Court of Appeals was the most reasonable one. For to justify reversal in such cases, the error must be clear or manifest; the interpretation must be inescapably wrong; the decision must be patently erroneous."

On the second point, if the debt of the transferor corporation had been really "canceled" it would have emerged from bankruptcy free of debt, its stockholders would have been its sole owners and it could have continued business. Instead of canceling its debt, its creditors took its property away from it and conveyed it to taxpayer. If one cancels our debt, we are better off. If a corporation's debt is "canceled" its stockholders are better off. They would

have been here if it had been canceled but it was not and they lost everything. Maybe we will cancel England's debt after the war. Maybe we will get territory for it as some senators now advocate. If a presidential candidate were to say we should cancel it, the average voter would understand he meant forgive it and not take Bermuda and other territory for it.

If the court concludes the word "canceled" (no question of debt reduction arises in this case) means forgiven, then section 270 has no application to this case and the decision of the Tax Court must be affirmed on this point and that of the court below reversed.

On the other hand, if this court concludes the debt was "canceled" and the statute, if read literally, applies, then it is submitted the court should follow the purpose of the statutes rather than the literal words (*United States* v. *American Trucking Associations*, 310 U. S. 541, 543, 544). The legislative history shows the purpose of section 270 of the Chandler Act was to compensate the government for tax lost by reason of the application of section 268. If section 268 did not save a debtor from tax, then section 270 was not to reduce the basis of its property. As pointed out by Mr. Paul in Debt and Basis Reduction", 15 Tulane Law Review, 1, in note 26, on page 7, Congressman Chandler thought this was the construction of the Act. He has stated this was the intent of Congress. Also, as pointed out by Mr. Paul in note 11, on page 3, of this article, Congressman Chandler blamed the confusion on the Treasury. Potent reasons support this construction. The conceded purpose of the Chandler Act was to facilitate and not impede federal bankruptcy reorganizations and, to quote from page 7 of Mr. Paul's aforesaid article: "No reduction of

basis was required in cases in which stock of the debtor or its transferee was issued for bonds—a common type of reorganization protected from recognition of gain by the Internal Revenue Code—and it does not seem reasonable that Congress could have intended in the Chandler Act to penalize expedient reorganizations which could have been freely undertaken outside of bankruptcy."

If the bonds had been exchanged for stock outside of bankruptcy, the old basis would have carried over. *Palm Springs Holding Co.* v. *Helvering*, 315 U. S. 185.

This court has often declared the rule that bankruptcy acts are to be literally construed and that "possible doubt as to the meaning of the section should be resolved in the light of the purpose of the act * * * to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh, free from obligations and responsibilities consequent upon business misfortunes" (Citing Cases) *Maynard* v. *Elliott*, 283 U. S. 273, 277. Moreover, the statute was intended to remedy the doubt arising from the *Kirby* case and a remedial statute should be construed "to give the relief it was intended to provide" *Bonwit, Teller & Co.* v. *United States*, 283 U. S. 258, and finally "if doubt arises as to the construction of a taxing statute, the doubt should be resolved in favor of the taxpayer". *Hassett* v. *Welch, Collector*, 303 U. S. 303, 314.

Congress was not passing a statute to require that tax returns of bankrupts be reopened and additional tax recomputed back to 1934. Returns for that year were due March 15, 1935. The three year statute of limitations expired March 15, 1938. This law was enacted June 22, 1938. If any tax had been paid on debt cancellation in 1934, its recovery was barred when this law was enacted. If con-

gress had intended the provision to be retroactive, it would have suspended the statute of limitations in such case.

Finally, the statute can well be construed not to apply to cases closed by final decree before it was enacted because section 276 (e) says "with respect to proceedings pending under those sections upon the effective date of this amendatory Act except" and the exceptions are carved out of "proceedings pending * * * upon the effective date of this amendatory Act." This was not one.

The court below held its decision debt was canceled rendered certain questions in case No. 29 moot: Should this case No. 28 be reversed they are not moot and case No. 29 should be reversed with directions to consider them in the light of this opinion.

All of which is respectfully submitted.

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APPENDIX.

Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as amended by the Act of June 22, 1938, c. 575, 52 Stat. 840, Sec. 1:

Sec. 268. Except as provided in section 270 of this Act, no income or profit, taxable under any law of the United States or of any State now in force or which may hereafter be enacted, shall, in respect to the adjustment of the indebtedness of a debtor in a proceeding under this chapter, be deemed to have accrued to or have been realized by a debtor, by a trustee provided for in a plan under this chapter, or by a corporation organized or made use of for effectuating a plan under this chapter by reason of a modification in or cancelation in whole or in part of any of the indebtedness of the debtor in a proceeding under this chapter.

(U. S. C. 1940 ed., Title 11, Sec. 668.)

Sec. 269. Where it appears that a plan has for one of its principal purposes the avoidance of taxes, objection to its confirmation may be made on that ground by the Secretary of the Treasury, or, in the case of a State, by the corresponding official or other person so authorized. Such objections shall be heard and determined by the judge, independently of other objections which may be made to the confirmation of the plan, and if the judge shall be satisfied that such purpose exists, he shall refuse to confirm the plan.

(U. S. C. 1940 ed., Title 11, Sec. 669.)

Sec. 270. [as further amended by the Act of July 1, 1940, c. 500, 54 Stat. 709]. In determining the basis of property for any purposes of any law of the United States or of a State imposing a tax upon income, the basis of the debtor's property (other than money) as is

transferred to any person required to use the debtor's basis in whole or in part shall be decreased by an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return, has been canceled or reduced in a proceeding under this chapter, but the basis of any particular property shall not be decreased to an amount less than the fair market value of such property as of the date of entry of the order confirming the plan. Any determination of value in a proceeding under this chapter shall not be deemed a determination of fair market value for the purposes of this section. The Commisioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order to reflect such decrease in basis for Federal income-tax purposes and otherwise carry into effect the purposes of this section.

(U. S. C. 1940 ed., Title 11, Sec. 670.)

Sec. 276. • • •

• • •

c. the provisions of section 77A and 77B of chapter VII, as amended, of the Act entitled "An Act to establish a uniform system of bankruptcy throughout the United States", approved July 1, 1898, shall continue in full force and effect with respect to proceedings pending under those sections upon the effective date of this amendatory Act, except that—

(1) if the petition in such proceedings was approved within three months prior to the effective date of this amendatory Act, the provisions of this chapter shall apply in their entirety to such proceedings; and

(2) if the petition in such proceedings was approved more than three months before the effective date of this amendatory Act, the provisions of this chapter shall apply to such proceedings to the extent that the judge shall deem their application practicable; and

(3) sections 268 and 270 of this Act shall apply to

any plan confirmed under section 77B before the effective date of this amendatory Act and to any plan which may be confirmed under section 77B on and after such effective date, except that the exemption provided by section 268 of this Act may be disallowed if it shall be made to appear that any such plan had for one of its principal purposes the avoidance of income taxes, and except further that where such plan has not been confirmed on and after such effective date, section 269 of this Act shall apply where practicable and expedient.

(U. S. C. 1940 ed., Title ii, Sec. 676.)

Treasury Regulations 86, promulgated under the Revenue Act of 1934, as amended by T. D. 4871, 1938-2 Cu. Bull. 130, and T. D. 5003, 1940-2 Cum. Bull. 107:

Art. 113 (b)—2. Adjusted basis: Cancellation of indebtedness.—In addition to the adjustments provided in section 113 (b)(1) and article 113 (b)—1 which are required to be made with respect to the cost or other basis of property, a further adjustment shall be made in any case in which there shall have been a cancellation or reduction of indebtedness in any proceeding under section 12, 74 (except in the case of a "wage earner" as defined in the Bankruptcy Act, as amended), or 77B or under Chapter X, XI, or XII of the Bankruptcy Act of 1898, as amended.

For the purpose of this article—

(A) Basis shall be determined as of the date of entry of the order confirming the plan, composition or arrangement under which such indebtedness shall have been canceled or reduced;

(B) Except where the context otherwise requires, property means all of the debtor's property other than money;

(C) No adjustment shall be made by virtue of the cancellation or reduction of any accrued interest unpaid which shall not have resulted in a tax benefit in any income tax return;

(D) The phrase "indebtedness incurred to pur-

chase" includes (i) indebtedness for money borrowed and applied in the purchase of property and (ii) an existing indebtedness secured by a lien against the property which the debtor, as purchaser of such property, has assumed to pay; and

(E) The term "fair market value" has reference to such value as of the date of entry of the order confirming the plan, composition or arrangement under which said indebtedness shall have been canceled or reduced.

Any determination of value in a proceeding under the Bankruptcy Act, as amended, shall not constitute a determination of fair market value for the purposes of this article.

The basis of any of the debtor's property which shall have been transferred to a person required to use the debtor's basis in whole or in part shall be determined in accordance with the provisions of this article.

Article 113 (b)—2, Treasury Regulations 94, as amended by the same Treasury Decision, is identical with the above quoted article.

APPENDIX B.

"TREASURY DEPARTMENT
Washington

Office of
Commisioner of Internal Revenue May 13, 1938
Refer to:
IT:RR:CAB

Mr. Harry Bergson, Attorney at Law,
31 State Street,
Boston, Massachusetts.
In re: Motor Mart Trust.

Sir:

Further reference is made to your letter of March 2, 1938, and enclosures ("SUBSTITUTE PLAN OF REORGANIZATION PROPOSED BY DEBTOR DATED SEPTEMBER 13, 1937") in which a ruling by this office is requested as to whether or not Motor Mart Trust (hereinafter called the taxpayer) will incur any income tax liability by reason of its proposed reorganization under Section 77B of the National Bankruptcy Act, as amended, under the substituted plan of reorganization presented to the District Court of the United States for the District of Masachusetts. It is stated that the plan has not been confirmed by the court for the reason that prior to such action the taxpayer desires to be assured that no taxable income will accrue to it as a result of the plan of reorganization.

In its petition for reorganization filed with the District Court the taxpayer states that it is a voluntary association under a written declaration of trust executed March 1, 1926 with beneficial interests divided into transferable shares and is a corporation within the meaning of the National Bankruptcy Act.

The substituted plan of reorganization shows the

taxpayer to have had the following outstanding capital liabilities on the date of filing the petition;

First Mortgage Bonds in the sum of $1,193,500.00 and accrued interest thereon in the sum of $298,375.00; Second Mortgage Bonds in the sum of $282,000.00, with accrued interest thereon of $101,990.00; 1,250 shares 8 percent cumulative preferred stock par value $100.00; and 5,000 shares class B common stock of no par value. It also shows outstanding scrip certificates dated May 16, 1932 due August 1, 1934 in the sum of $60,750.00 representing interest on certain of the first mortgage bonds due September 1, 1932 and March 1, 1933 and not paid in cash. It further shows unpaid trustees' compensation in the sum of $68,651.77, accrued prior to January 1, 1933. The letter of the representative of the taxpayer states, however, that the total face value of bonds affected by the proposed plan is $1,475,500.00 and the amount of unpaid interest thereon up to March 1, 1938 is $471,490.00.

The proposed plan is that all of the foregoing securities and debts be paid and retired by the taxpayer issuing 9,548 shares of convertible preferred of the par value of $50.00 per share and 6,437 shares of common of the par value of $5.00 per share. The convertible preferred under the terms of the plan are convertible at any time prior to January 1, 1944 into common shares of the taxpayer.

It is proposed that the holders of the first mortgage bonds shall receive under the plan for each one $1,000.00 first mortgage bond accompanied by coupons payable on or after September 1, 1933 eight convertible preferred shares and four common shares of the taxpayer. Holders of first mortgage bonds of the denomination of $500.00 acompanied by coupons as aforesaid shall receive four convertible preferred shares and two common shares. The holders of the second mortgage bonds are to receive under the plan for each one $1,000.00 second mortgage bond accompanied by coupons payable on or after September 1, 1932 five common shares of the taxpayer. Holders of second

mortgage bonds of the denomination of $500.00 accompanied by coupons as aforesaid shall receive two and one-half common shares. The holders of the present common and preferred stock of the taxpayer will not receive anything under the plan, their interest being entirely wiped out, the effect of the plan being to make the present bondholders the new beneficiaries of the taxpayer.

The trustees for their claim of $68,651.77 for compensation accrued prior to January 1, 1933 are to receive 253 common shares of the taxpayer.

It is proposed that the holders of scrip certificates, above referred to, are to be paid $2.00 for each certificate of the face value of $30.00 and $4.00 for each certificate of the face value of $60.00 or a total in cash of $5,050.00.

It is further proposed that any merchandise or miscellaneous creditors who may properly establish their claims will be paid in full.

In the exchange of convertible preferred shares and common shares for first and second mortgage bonds, and accrued interest thereon, no attempt is to be made to allocate the amount of stock being given in exchange for the principal of the bonds and the amount given for the accrued interest due thereon.

The representative of the taxpayer further states that in the past the taxpayer has used the accrual basis of keeping its records and reporting its income and has deducted from its annual income the amount of the accrued interest on the bonds although such interest was in fact never paid. However, the taxpayer would not be chargeable with any taxable income for the years in which these accruals were deducted for the reason that after normal allowances for depreciation there would still exist a deficit greater than the amount of the interest on the bonds.

Under the facts presented, and as above outlined, it does not appear that there is involved in the plan any question of the cancellation of indebtedness. In each instance with the exception hereinafter noted

where an indebtedness of the corporation is involved and is being extinguished it is to be effected through an exchange and a payment of the indebtedness rather than through cancellation of the indebtedness, the consideration being the exchange of its now convertible preferred shares and common shares for its first and second mortgage bonds, and the accrued interest thereon. The same situation exists with respect to the satisfaction of the unpaid compensation due trustees which had accrued prior to January 1, 1933. The trustees accept the common stock in payment and discharge of their claim. It is, therefore, the opinion of this office that no taxable income will be realized by the taxpayer by reason of these transactions.

Concerning the purchase of $60,750.00 of scrip certificates which had been issued in payment of interest on certain first mortgage bonds due September 1, 1932 and March 1, 1933, for the sum of $5,050.00, cash, or at the rate of $2.00 for each certificate of the face value of $30.00 and $4.00 for each certificate of the face value of $60.00, it does not appear from the information submitted for what taxable years this scrip was issued in payment of interest on its bonds. It is assumed, however, since it is stated that taxpayer has used the accrual method of keeping its records and filing its income tax returns, that the taxpayer deducted in its returns for the years for which the scrip was issued the interest represented by the scrip. While the debt of the taxpayer in the purchase of this scrip at the discount stated is not strictly a cancellation of the indebtedness, considering it to be a part of the plan of reorganization of the taxpayer in a bankruptcy proceeding it is not believed any tax liability should be asserted with respect to this transaction unless the taxpayer has had the benefit in prior years of a reduction of its tax liability on account of deductions from gross income by reason of the accrual of the interest items for which the scrip was issued. With respect to any such amount, if the period of limitation on assessment of taxes has not expired for the years

for which such deductions were taken, the returns for such years will be readjusted. If the period of limitation on assessment for such years has expired such amounts, less cost of the scrip will be included in income for the year in which the purchase scrip occurs.

Respectfully,

(Sgd.) Guy T. Helvering
Commissioner."